Economic Update

THIRD QUARTER 2024

OCTOBER 2, 2024

3Q2024 – FED EASING STARTS WITH A BANG

After months of debate and deliberation, the Fed's easing cycle finally arrived in September. Following a weak July employment report, market expectations for a 50 basis point (bps) cut proved accurate. Unfortunately, the path forward is never clear. As we hurtle toward the end of the year, the market chorus now wonders how accommodative the Fed will ultimately be. See the next section for more details.

The market reaction to the Fed's cut has been positive with risk assets sending the all-clear. In the days following the September FOMC meeting, the S&P 500 equity index logged multiple all-time highs. Interest rates continued a rally that began in May, with the 2s-10s curve steepening into upward sloping territory for first time in 26 months. Sniffing out the pending shift in monetary policy, 2-year Treasuries rallied a whopping 111 bps in the third quarter while 10-year Treasuries rallied 61 bps, leading to a 50 bps bull steepener. While at first glance this curve reshaping is considerable, it is perfectly within historical norms set by the months leading up to the beginning of an easing cycle, particularly when a recession is not imminent.

Despite two years of restrictive monetary policy, market measures of liquidity risk and interest rate volatility have remained low, resulting in financial conditions that are already extremely easy. Naturally, the path forward depends on the trajectory of economic conditions along with the Fed's policy response. If the economy falters and requires more aggressive easing, history would suggest additional bull steepening of the yield curve. While the forward curve indicates additional steepening over the next year, the expected magnitude of 35-40 bps feels consistent with a soft landing.

2Q GDP growth was revised up to 3.0% q/q annualized after an initial estimate of 2.8%. Personal consumption accelerated to 2.8% q/q annualized from 1.9% in the first quarter. Gross private investment picked up to 8.3% q/q annualized, despite a sharp drop in residential fixed investment. 3Q GDP growth is expected to remain strong at 2.5-2.9% q/q annualized. Full year growth for 2024 is now projected to be 2.5%-2.7%. Recession probabilities remain low with the median recession probability forecast on Bloomberg at only 30%.

A HAWKISH CUT AND POLITICAL UNCERTAINTY

While the Fed remained on hold at its policy meeting in July, the official statement acknowledged both sides of the Fed's dual mandate, suggesting that at the margin it will be more sensitive to weakening employment going forward. In the post-meeting press conference, Fed Chair Powell went on to add that a cut was on the table for September, dependent on continuance of the current trends. Within a few days of this message, the July employment report was particularly weak, triggering a debate regarding a 50 bps cut in September or potentially sooner. At the annual Jackson Hole Economic Policy Symposium held the third week in August, Powell highlighted the weakening labor market and the Fed's desire to limit further increases in unemployment. The overall dovish tone of his address solidified a rate cut in September. As the labor market continued to weaken in August, market expectations leaned modestly in favor of a 50 bps rate cut.

Quarterly Key Points

- After months of debate and deliberation, the Fed's easing cycle finally arrived in September. Following a weak July employment report, market expectations for a 50 basis point (bps) cut proved accurate. As we hurtle toward the end of the year, the market chorus now wonders how accommodative the Fed will ultimately be.
- Although a 50 bps cut is dovish in tone, the updated Summary of Economic Projections and press conference leaned more hawkish. Within the updated projections, the median indicates the Fed plans on two additional 25 bps cuts between now and year end with the distribution skewed towards two cuts or less.
- 2Q GDP growth was revised up to 3.0% q/q annualized after an initial estimate of 2.8%. 3Q GDP growth is expected to remain strong at 2.5-2.9% q/q annualized. Full year growth for 2024 is now projected to be 2.5%-2.7%.
- Inflation measures continue to trend in the right direction despite core inflation numbers bouncing up modestly month-over-month and year-over-year more recently. 2-year breakeven inflation rates fell as low as 1.47% in mid-September but climbed back to 1.77% to end the quarter. Long-term inflation expectations are between ~2.10% and 2.25%.
- Annual revisions to GDI led to upward revisions to personal income growth and the personal savings rate, which suggests that consumers have been earning and saving more than previously thought, helping to explain the surprising resilience of consumer spending despite restrictive monetary policy over the past several years.

Our View

- The market is expecting a series of controlled rate cuts that extends through at least the middle of next year. A recession does not appear to be on the short-term horizon; however, the Fed will need to walk a fine line to orchestrate a soft landing. In our view, caution is still warranted.
- Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add spread where valuations make sense. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

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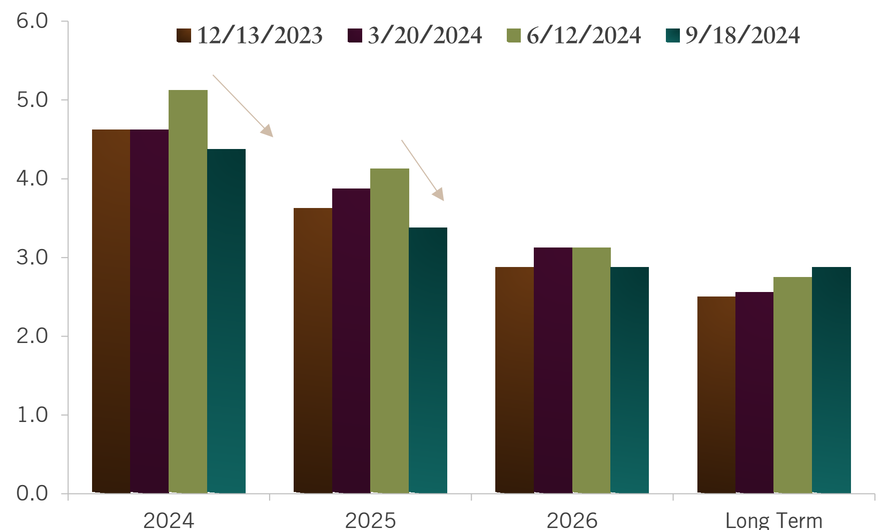
As previously mentioned, the Fed subsequently delivered a 50 bps cut at the policy meeting in September. Although largely symbolic, the vote included a dissent for the first time since 2005 with one FOMC member voting for a 25 bps cut. The official FOMC statement indicated that the Fed has "gained greater confidence that inflation is moving sustainably toward 2 percent" and reinforced that the risks to inflation and employment are more balanced. The statement added that the Fed is "strongly committed to supporting maximum employment" in addition to achieving its inflation goal.

Although a 50 bps cut is dovish in tone, the updated Summary of Economic Projections (SEP) and Powell's press conference leaned more hawkish. Within the updated projections, the median indicates the Fed plans on two additional 25 bps cuts between now and year end with the distribution skewed towards two cuts or less (Figure 1). Meanwhile, the market is currently pricing in 75 bps of cumulative cutting over the remaining two FOMC meetings this year. Additionally, when asked about quantitative tightening, Powell responded that the Fed has no plans to reduce the pace of balance sheet runoff anytime soon, citing ample liquidity and excess reserve balances in the system.

FIGURE 1: FOMC MEDIAN FED FUNDS RATE PROJECTIONS (%)[1]



[1]Source: Federal Reserve.

This "hawkish cut" accomplished several things for the Fed. First, the unfortunate juxtaposition of the July FOMC meeting and a particularly weak July employment report a few days later left the market thinking the Fed was once again falling behind the curve. The 50 bps cut in September can be interpreted as a catch-up for the 25 bps cut that should have happened in July, plus the 25 bps that was widely expected to occur in September, putting the Fed back on track. Alternatively, the 50 bps cut could be considered a reinforcement of the Fed's commitment to strong employment markets. Regardless, the Fed wanted to send a clear signal that it is not falling behind and is committed to both stable prices and full employment.

Last March, Congress approved a continuing resolution that funded the government through the September 30 fiscal year. Unsurprisingly, Congress resorted to another continuing resolution in late September to avoid a shutdown that would have occurred on October 1. The new stop-gap measure is limited in scope and extends funding only until December 20. Regardless of the motivation, Congress has routinely failed to pass funding bills in a timely manner while using the threat of shutdown to negotiate short-term spending. With another debt ceiling showdown looming in January and the election in November, political uncertainty could be a source of volatility heading into next year.

INFLATION TRENDING LOWER

Inflation measures continue to trend in the right direction despite core inflation numbers bouncing up modestly month-over-month and year-over-year more recently. Headline CPI measured 3.0% y/y, 2.9% y/y, and 2.5% y/y in June, July, and August respectively, while core CPI increased by 3.3% y/y, 3.2% y/y, and 3.2%y/y during the same period. On a month-over-month basis, headline CPI measured 0.2% in both July and August after falling by -0.1% in June. Meanwhile, core CPI increased by 0.1%, 0.2%, and 0.3% in June, July, and August. On a rolling 3-month basis, headline CPI increased by only 0.1% m/m in August whereas core CPI measured 0.2% m/m. These rolling averages imply an annualized run rate of approximately 1.5% to 2.5%, squarely in the Fed's target range and considerably lower than the 6.0% to 7.0% annualized run rate in late 2022.

PCE and PPI show a similar pattern. Headline PCE fell to 2.2% y/y in August after bouncing up to 2.5% y/y in July, while core PCE edged higher to 2.7% y/y. Measured month-over-month, both headline PCE and core PCE were just 0.1% in August. Headline PPI measured 0.0%

m/m and 0.2% m/m in July and August, while core PPI measured -0.2% m/m and 0.3% m/m during the same period. On a year-over-year basis, core PPI is down to 2.4% in August while headline PPI is down to 1.7%.

2-year breakeven inflation rates fell as low as 1.47% in mid-September but climbed back to 1.77% to end the quarter. Long-term inflation expectations, represented by the 5-year breakeven, 10-year breakeven, and 5-year, 5-year forward breakeven rates, are between ~2.10% and 2.25%. In our view, the decrease in 2-year inflation expectations and the stability of longer-term inflation expectations are consistent with the Fed continuing to ease monetary policy going forward.

ECONOMY SLOWING BUT STILL SOLID

The weaker tone in the labor market that began in late spring continued through the summer. Non-farm payrolls added 118k, 144k, and 142k jobs in June, July, and August, respectively. Furthermore, measures of job gains have underperformed expectations with prior month revisions often resulting in further reductions. The unemployment rate slowly increased to 4.2% as of the end of August. The labor force is higher by ~800k over the past three months while total employment is higher by ~350k. Encouragingly, many see the increase in unemployment as the result of workers reentering the labor force and not due to larger scale layoffs. Additionally, despite increasing unemployment, unemployment claims remain well within historical norms. Job openings have continued to fall to only eight million jobs available, while the quits rate has been steady at around 2.0%-2.2% for the past handful of months.

Consumer spending remained solid throughout the summer. Personal income growth measured 5.6% y/y in August. However, upward revisions as a result of annual adjustments to Gross Domestic Income (GDI) suggest that real personal income growth has been slightly stronger than previously thought. Adjusted retail sales measured 1.1% m/m in July and 0.1% m/m in August, and nominal personal consumption expenditures increased by 0.2% m/m in August after a whopping 0.5% m/m increase in July. The personal savings rate, measured as a percentage of disposable income, was 4.8% in August. Here as well, annual revisions to GDI led to an upward revision to the personal savings rate, which suggests that consumers have been earning and saving more than previously thought, helping to explain the surprising resilience of consumer spending despite restrictive monetary policy over the past several years.

Business activity, on the other hand, was relatively uneventful for the quarter. The ISM Manufacturing PMI remained just below 50 throughout the quarter, landing at 47.2 in September, while the ISM Services PMI regained some momentum, coming in at 51.4 in July and 51.5 in August after briefly dipping below 50 in both April and June. Industrial production and capacity utilization were largely unchanged as well. Industrial production has been between 102 and 103 since January and capacity utilization has hovered just below 80% since late 2022.

30-year fixed mortgage rates, as measured by the Freddie Mac weekly survey, fell to 6.08% in late September marking the lowest rate since fall of 2022 (Figure 2). Unfortunately, this drop has not yet translated into home sales volumes. Existing home sales volume slipped back to only a 3.9-million-unit annualized pace in August. New home sales volumes have bounced around 600-700 thousand units annualized for the past several years. Existing home supply remains very low at ~4 months. Many argue that the low level of existing home supply is evidence of a strong lock-in effect of extremely low financing. The supply of new homes on the other hand, remains elevated at ~8 months, well above pre-pandemic levels.

FIGURE 2: FREDDIE MAC 30-YEAR MORTGAGE SURVEY RATE[2]

[2]Source: Bloomberg.

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LOOKING AHEAD

The economic landscape has shifted modestly, and monetary policy has entered a new phase accordingly. Consumer spending is holding up despite labor markets and inflation is trending lower. The path is clear for the Fed to unwind restrictive monetary policy in an orderly fashion, and the market has responded favorably. The market is expecting a series of controlled rate cuts that extends through at least the middle of next year, commensurate with falling inflation. A recession does not appear to be on the short-term horizon; however, the Fed will need to walk a fine line to orchestrate a soft landing.

In our view, caution is still warranted. The trajectory of the economy is still unknown, particularly as it pertains to labor markets, and a harder landing is certainly not out of the question. Alternatively, inflation could re-ignite leading to a slower pace of policy easing than currently expected. Indeed, the progress on several measures of core inflation may be slowing, and the Fed's message leaned slightly hawkish for an easing cycle that started with a 50 bps cut. The upcoming U.S. elections and escalating geopolitical tensions are additional sources of potential volatility.

Although policy easing has started, an extended period of restrictive monetary policy means liquidity will continue to be a concern and volatility in risk assets could return, reflecting fatter tails and the risk of unintended consequences. Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add spread where valuations make sense. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

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